

Foreign Currency Fluctuation Account

by Major Jim O'Brien

...the Foreign Currency

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For many, the Foreign Currency Fluctuation Account (FCFA) is one of the great mysteries of our time. In my mind I can picture the character George Kastanza, on the TV series Seinfeld, pretending to fully understand FCFA and trying to impress his boss with his knowledge...not even Jerry, Elaine, or Cosmo Kramer could bail him out as he fumbles through an explanation of the daily rate versus the budget rate! In an overseas environment it is critical that financial managers throughout the base have a working knowledge of FCFA.

The Resource Management System is structured on the concept of decentralized management. In order for the system to work, financial decision-makers must be trained to effectively execute a budget, including an understanding of FCFA. The job of training Responsibility Center Managers (RCMs), Resource Advisors (RAs), and Cost Center Managers (CCMs) rests with the Wing Comptroller and their Financial Analysis Office.

Be Careful What You Ask For

On more than one occasion, I can recall a budget officer being on the ropes at a Financial Management Board (FMB) meeting—tough questions coming from all directions...why was my program cut? Influenced by the angry mob, the Commander would momentarily seem to lose faith in the Comptroller team. Just when it looked like the home team was about to go down, the budget officer would say the

four magic letters F C F A. The response was predictable. Eyes glazed over and everyone in the meeting was now in a trance. Heads nodded as if they understood. The pressure was off, crisis averted.

As comptroller professionals we pride ourselves in knowing our base and our programs. We've all been told that a good budget officer knows more about the base than anyone else. This knowledge is critical to our success and may even lead us to believe that we are the best qualified to make all financial decisions on the base. However, we all know we are advisors in the process. We should know the pulse of the operation in order to make sound recommendations, but ultimately financial decisions must be made by operational commanders. Ensuring commanders have a working knowledge of some of our complex issues such as FCFA is a prerequisite to success.

What Purpose Does FCFA Serve?

There are many opinions as to why we have FCFA, from the practical, as a budgeting tool, to conspiracy theorists who think FCFA may be somehow connected to an attempt to defeat the American military forces. An FCFA rate that is vastly different from the daily rate (market rate at the time of payment) results in accounting records that reflect expenses that are either significantly overstated or understated. In Turkey, for instance, accounting records reflect Turkey Base Maintenance Contract expenses for FY96 of over \$52.3M. However, the actual payments only came to \$40.1M—a major disconnect driven by an FCFA rate of 48,096TL to the dollar, when the actual rate of exchange reached 90,000 by yearend. While this gives the conspiracy theorists something to talk about and may be tied in to a political agenda or motive, this article will center on the use of FCFA as a budget tool. Who knows, maybe FCFA is OSD's way of making our Congressional leaders' eyes glaze over during budget hearings!

By setting a constant rate, overseas bases do not have to deal with daily fluctuations in currencies. Sudden changes in the value of a currency are absorbed by the FCFA and bases do not need additional funds every time the rate becomes less favorable. This also means that a base doesn't have excess funds when a rate becomes more favorable, because the FCFA rate is used instead of the daily rate (Note: most complaints on

FCFA come from areas where the actual rate is more favorable than the FCFA rate). The success of the budget tool is based upon some concepts that we will discuss later in the article, and there are definitely some economic factors that diminish the value of FCFA as a budgeting tool.

Let's look at a quick example that illustrates FCFA's role as a budgeting tool. For our example, rubles will be the foreign currency and the daily exchange rate is 10 rubles to one US dollar. To keep it simple we'll also set the budget rate at 10 rubles to one US dollar.

Without FCFA: Each month, Base X pays a local contractor 1,000 rubles for refuse collection services. At ten rubles to the dollar, the cost to the base is \$100 per month. Six months into the fiscal year, market conditions change and the daily rate drops significantly to four rubles to the dollar. The monthly bill skyrockets to \$250 per month (1,000 rubles/4). Without FCFA, our base is hard hit by this change in rate.

With FCFA: Now, let's assume we have an FCFA. When the daily rate dropped to four rubles to the dollar, the base would see no impact because the FCFA would absorb the increase. The contractor still gets paid 1,000 rubles and the actual cost to the US government is still \$250 (1,000 rubles/4). However, the base O&M is only charged 100 dollars (1000 rubles divided by the budget rate of 10). The FCFA pays the difference between the actual rate (\$250) and the budget rate (\$100). In this example the base O&M is charged \$100 and the FCFA is charged \$150. Therefore, the FCFA served its purpose as a budgeting tool, as Base X was not affected by the rate change. If only it was always this easy...

How Are Budget Adjustments Made?

One of the keys to ensuring the FCFA system works is properly identifying the portion of a base, or command, budget that is paid in local currencies. Each year, Major Commands submit financial plans to SAF/FMB that contain an "Exhibit Q" which breaks out expenses by currency and commodity. This breakout serves as the baseline for funding adjustments at Initial Distribution based upon new Budget rates. Likewise, the Major Commands request a similar exhibit from the bases. This exhibit is critical to the process, and the data must be accurate or the system breaks down. Let's follow our previous example of rubles at Base X.

New Budget Rate: To keep things very simple, let's assume that the only bill Base X pays in local currency is the refuse collection contract. In the "Exhibit Q," \$1,200 dollars would be identified as being sensitive to FCFA. This is computed based upon the actual amount of rubles billed (1,000 rubles X 12 months) divided by the budget rate in the current year (ten for this example). Based upon the new economic assumptions/conditions, the budget rate for the next fiscal year is being changed from ten rubles to the dollar to four rubles to the dollar. Base X's funding at Initial Distribution should be adjusted by taking the amount sensitive to FCFA (\$1,200) multiplied by the old budget rate (ten rubles to the dollar) and divided by the new budget rate (four rubles to the dollar). In this case, the O&M funding is adjusted from the original \$1,200 to \$3,000. It is important to point out that although Base X receives an additional \$1,800, their purchasing power is unchanged as the new monthly charge to O&M will increase based on the new budget rate of four rubles to the dollar.

It's also important to note that funds can be withdrawn when the budget rate changes as well. If the budget rate in our example went from ten rubles to twenty rubles to the dollar, Base X's funding at Initial Distribution would be adjusted by taking the amount sensitive to FCFA (\$1,200) multiplied by the old budget rate (ten rubles to the dollar) and divided by the new budget rate (20 rubles to the dollar). In this case, the adjusted O&M amount would be \$600 and Base X's funding would be decreased by \$600. As with the earlier case, Base X's purchasing power is unchanged as the new monthly charge to O&M will decrease based on the new budget rate of 20 rubles to the dollar. The pitfall in the system is if the "Exhibit Q" is inaccurate. For instance, if Base X did not identify any FCFA sensitivity, they would drive an unfunded of \$1,800 when the Budget rate dropped to four rubles to the dollar. The bottomline is when done correctly, adjustments based on new Budget rates are purely mathematical and do not increase or decrease a base's purchasing power. This is great in theory, but a little more difficult in practice.

How Do the Budget Rate and Daily Rate Interact?

With the dozens of currencies the Air Force deals with, some of which are very volatile, it is difficult to set rates that track closely with the daily rate. Budget rates can be adjusted during the course of the fiscal year, as they were in FY97, but frequently adjusting the rates to track with the daily rates would somewhat defeat the purpose of an FCFA. The changes in the rates during FY97 were a welcome sight at many locations since funds were not withdrawn to accompany the more favorable rates. Excess funds were then available for

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reprogramming to unfunded requirements. However, the downside to the rate changes were a series of accounting adjustments to reflect the changed rates. Given that, FY97 was more of a “one-time” good deal, and we should not expect to see too many rate changes in mid-stream.

The “foot-stomper”, to make sure all financial decision-makers understand, is that the vendor is not impacted in any way by the budget rate, and neither is the US Treasury. The vendor is paid in the local foreign currency and the US Treasury pays the daily rate of exchange at the time of the payment. The FCFA is only an internal accounting tool. The dead give-away that your financial manager’s do not understand FCFA is when they say I can’t believe we’re paying the vendor at that rate... it shouldn’t cost that much!

High Inflation and Unstable Currency—A Challenging Combination

There are factors that limit the effectiveness of FCFA to include inaccurate rates, high inflation, and unstable currency. When the Budget Rate varies greatly from the daily rate, the actual costs charged to the Wing are distorted. This leads to confusion and misunderstanding among financial decision-makers who think FCFA is hurting their O&M budget. It’s hard to explain why a unit’s funds are being charged \$100, for something that only costs \$50. However, if FCFA funding adjustments were made down to the unit-level, these high costs are built in to their funding. Where we can run into trouble is when the amount of purchases made using a foreign currency changes significantly from the previous year. To some degree this is inevitable, as financial managers will avoid spending funds on the local economy if the rate is unfavorable to their budget.

Another factor that complicates the process is high inflation coupled with an unstable currency. In fact, FCFA has an opposite effect than desired in these cases. A case in point is Turkey where annual inflation can exceed 100% per year. However, as inflation soars, so does the value of the dollar versus the Lira. This actually results in a relatively stabilizing effect on the purchasing power of the US dollar. However, the Budget rate does not change to keep pace with the strengthening dollar and inflation. As time goes on in the fiscal year, the inflation drives the bills higher (utilities, civ pay, etc.) and the purchasing power of O&M funding decreases as the year goes by. Let’s look at a final example to illustrate this:

FCFA Impact in High Inflation Economy: Base Y purchases 1,000 gallons of water per month from a local vendor for flightline workers. Each gallon costs ten rubles on 1 October, with the daily rate and the Budget Rate both equal to ten rubles to the dollar. The bill for October is \$1,000 (10,000 rubles divided by the budget rate (ten)). Inflation is ten percent per month, and in November the water costs 11 rubles per gallon. The value of the dollar rose to keep pace with the high inflation, and the daily rate rose to 11 rubles to the dollar. The vendor is paid the 11,000 rubles at cost of \$1,000 to the US Treasury (11,000 divided by the daily rate (11 rubles)). So there was no change in the amount paid by the US Treasury. However, the unit funds are charged \$1,100 (11,000 rubles divided by the budget rate (ten rubles)). The extra \$100 over what was actually paid to the vendor is deposited into the FCFA. The bad news for Base Y is that this inflation was not programmed into their funding line, and the impact becomes greater as the inflation and daily rate skyrocket throughout the fiscal year. The good news is it’s relatively easy to quantify in terms of unfunded requirements.

Summary

The FCFA is a useful, but often misunderstood, budgeting tool. From a macro perspective it is hard to deny the value of the system, despite some major disconnects at some locations. The system will never be perfect, but by ensuring we properly identify what portion of our program is sensitive to foreign currency, we can greatly increase the effectiveness of FCFA. Additionally, rates must be set as close to the daily rate as possible or costs become too distorted to present a true picture of operating costs in overseas areas. If financial decision-makers generally understand how FCFA works, then these concerns become irrelevant. However, if we in FM don’t take the time to ensure we explain the process, crucial decisions may be made on accounting data that does not tell the whole story. Our job is to tell that story.



About the Author

Major Jim O’Brien is currently Chief, Integration and Support Branch at Headquarters, Pacific Air Forces. He has a BS from Norwich University in Business Administration and a MS in Systems Management from the University of Southern California. His active duty experience includes a variety of accounting and finance and budget positions, as well as a tour on the ACC IG Team. Prior to his current position, Maj O’Brien was the comptroller at Incirlik AB TU. He’s a member of the Aloha Chapter of the American Society of Military Comptrollers.

